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Representatives

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FOREIGN ASSISTANCE

U.S. Funds to Two  
Micronesian Nations  
Had Little Impact on  
Economic Development  
and Accountability Over  
Funds Was Limited

Statement of Susan Westin, Associate Director, International Relations and  
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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to provide information you requested regarding economic assistance provided by the United States from 1987 through 1998, under the Compact of Free Association, to the Federated States of Micronesia and the Republic of the Marshall Islands. In 1986, the U.S. government entered into an international agreement, the Compact of Free Association, with each nation. This Compact represents a continuation of U.S. financial support that had been supplied to these areas for almost 40 years after World War II under the United Nations Trust Territory of the Pacific Islands.

Specifically, my testimony will address (1) the use of Compact funding by the Federated States of Micronesia and the Republic of the Marshall Islands, (2) the progress made by both nations in advancing economic self-sufficiency, (3) the role of Compact funds in supporting economic progress, and (4) the amount of accountability over Compact expenditures. My statement will be accompanied by photographs of sites we visited that were funded with Compact money in the Federated States of Micronesia and the Republic of the Marshall Islands. In addition, we will publish a report discussing these issues in more detail in September 2000.

The information I will provide is based on our review of annual financial statements and audits, planning and reporting documents from both nations, and discussions with senior officials from the Departments of the Interior and State. We also visited the Federated States of Micronesia and the Republic of the Marshall Islands and discussed the Compact with government and other officials, visited projects funded by the Compact, and reviewed documentation related to Compact expenditures maintained by both countries.

U.S. direct financial assistance under the Compact, which ends in 2001, is intended to help the governments of the two countries in their efforts to advance their economic self-sufficiency. Direct payments, or transfers of Compact funds, to both island nations are made by the Department of the Interior, the agency responsible for providing and monitoring Compact assistance.<sup>1</sup> These payments can be used for general government operations; capital projects (such as building roads or schools); and to support targeted sectors, such as energy and communications, specified in the Compact. In addition to receiving direct payments, both countries are eligible to use numerous U.S. federal services and programs such as the U.S. Weather Service, Pell grants for higher education, and business or home loans. The FSM and the RMI also receive some assistance from other countries. In the fall of 1999, negotiations between the Department of State and the two nations began on how to renew economic assistance and certain national security provisions in the Compact that will expire in 2001.

In May, we reported that the United States had provided over \$2.6 billion in total U.S. assistance to both countries from fiscal years 1987 through 1999, based on figures given

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<sup>1</sup> The Department of the Interior's Office of Insular Affairs currently has two people that work exclusively with the two Compact nations, one in Washington, D.C., and one in the Federated States of Micronesia. No Interior personnel live in the Republic of the Marshall Islands. There are three to four additional Interior staff in Washington, D.C. that work with the Compact nations as needed.

to us by 19 U.S. government agencies.<sup>2</sup> This assistance included direct payments under the Compact for economic growth and compensation for nuclear testing, as well as U.S. program assistance. In our May report, we concluded that the U.S. Department of the Interior had not maintained reliable data on the amount of U.S. assistance provided to the FSM and the RMI by all U.S. agencies. We recommended that, should the Department of the Interior retain oversight responsibility as a result of the current negotiations, the Department develop a system to obtain and maintain data on all U.S. assistance by, for example, making agreements with other U.S. agencies to regularly report assistance provided to both countries.

In this testimony, I will discuss how the FSM and the RMI spent direct payments provided under the Compact by the Department of the Interior to both countries to promote economic growth during the years 1987 through 1998. I will, however, refer to total U.S. assistance, which includes program assistance provided by all U.S. government agencies, during my discussion of economic self-sufficiency.

## SUMMARY

The Federated States of Micronesia and the Republic of the Marshall Islands spent about \$1.6 billion in Compact funds on general government operations, capital projects, and targeted sectors, such as energy and communications, from fiscal years 1987 through 1998. The two countries have used the funding differently. The Federated States of Micronesia used about 47 percent (\$510 million) of its \$1.08 billion in Compact funds to support general government operations such as salaries and travel. The Republic of the Marshall Islands spent 45 percent (\$230 million) of its \$507 million in Compact funds on capital projects such as developing physical infrastructure, establishing businesses, and servicing debt. Both countries together issued \$389 million in Compact revenue-backed bonds from the late 1980s to the mid-1990s in order to obtain more funding during the earlier years of the Compact. As a result of issuing these bonds, the Republic of the Marshall Islands has spent 42 percent (\$217 million) of its Compact funds for debt service, leaving limited Compact funds available for current government operations and investment.

The Federated States of Micronesia and the Republic of the Marshall Islands have made some progress in achieving economic self-sufficiency since 1987, though both countries remain highly dependent on U.S. assistance which has maintained artificially high standards of living. We used dependence on U.S. assistance, or total U.S. funds<sup>3</sup> as a percentage of total government revenues in each country, as an indicator to gauge economic self-sufficiency. The reliance on U.S. funding as a percentage of total government revenue in the Federated States of Micronesia fell from 83 percent in fiscal year 1987 to 54 percent in 1998. The Republic of the Marshall Islands also reduced its reliance on U.S. funding somewhat, from 78 percent in 1987 to 68 percent in 1998. Scheduled decreases in Compact direct payments as well as increases in locally

<sup>2</sup> See Foreign Relations: Better Accountability Needed Over U.S. Assistance to Micronesia and the Marshall Islands (GAO/RCED-00-67, May 31, 2000).

<sup>3</sup> For our assessment of economic self-sufficiency we use total U.S. funds, which consist of all direct payments under the Compact as well as U.S. program assistance.

generated funds in areas such as fishing license fees are examples of why reliance on U.S. funding has decreased.

Compact expenditures to date have led to little improvement in economic development in the Federated States of Micronesia and the Republic of the Marshall Islands. Substantial Compact expenditures used to maintain high levels of public sector employment have acted as a disincentive to private sector growth. Both countries have also spent Compact funds on infrastructure projects, such as electrical power and telecommunications systems, that they viewed as critical to creating an environment attractive to private businesses. However, these projects have not generated significant private sector activity. Finally, investment of Compact funds in business ventures has been a failure. During our work, we found that many Compact-funded projects had experienced problems because of poor planning and management, inadequate construction and maintenance, or misuse of funds.

The governments of the Federated States of Micronesia, the Republic of the Marshall Islands, and the United States have provided limited accountability over Compact expenditures. Although the Compact established accountability requirements for all 3 countries, none of the governments fully used these mechanisms to ensure that Compact funds were spent effectively or efficiently. While the Federated States of Micronesia and the Republic of the Marshall Islands generally prepared planning and reporting documents required under the Compact, most of these documents could not be used to determine if Compact funds were being spent to promote economic development. Furthermore, neither nation provided adequate financial or programmatic control over Compact funds, as documented in audit reports since 1987. In addition, the U.S. government did not meet many of its oversight obligations. For example, it did not hold required annual consultations to assess progress under the Compact until 1994, losing a valuable opportunity to provide guidance on the goals and uses of Compact funds. Moreover, disagreements between the Departments of State and the Interior over Compact responsibilities, as well as Interior's view that the Compact contained restrictive provisions that impaired its ability to act, further limited oversight.

## BACKGROUND

In 1986, the United States entered into a Compact of Free Association with the Federated States of Micronesia (a nation comprised of the four states of Kosrae, Pohnpei, Chuuk, and Yap), or FSM, and the Republic of the Marshall Islands, or RMI. These two small island nations are located just north of the equator in the Pacific Ocean with populations of 131,500 and 50,500, respectively, as of 1999. Through this Compact, the FSM and the RMI became Freely Associated States, no longer subject to U.S. administration under the United Nations Trust Territory of the Pacific Islands. The Compact, which consists of separate international agreements with each country, was intended to achieve three principal U.S. goals. These goals were to (1) secure self-government for each country; (2) assure certain national security rights for the FSM, the RMI, and the United States; and (3) assist the FSM and the RMI in their efforts to advance economic self-sufficiency.

The first two objectives have been met. The FSM and the RMI are independent nations and are members of international organizations such as the United Nations. (However, both countries maintain a special relationship with the United States through the Compact, and citizens of both nations are able to live and work in the United States as nonimmigrants.) Additionally, national security objectives were achieved. Under the Compact, the United States agreed to defend the FSM and the RMI, gained access to their territory for military use, and secured the right to deny military access to the region to other countries. These security provisions will continue indefinitely unless mutually terminated. In a 1986 Compact-related agreement with the RMI, the United States secured continued access to military facilities (a missile testing and space operations site) on Kwajalein Atoll for a period of 15 years and the right to extend the access for an additional 15 years (a right the United States exercised in September 1999).

The third objective of the Compact, promoting economic self-sufficiency (a term that is not defined in the Compact), was to be accomplished primarily through direct financial payments to the FSM and the RMI. The largest funding provision provides specific levels of funding for the FSM and the RMI over a 15-year period (1987-2001), with amounts decreasing every 5 years. These funds were provided to cover general government and capital expenditures. Additional Compact provisions target funding for use in specific sectors, such as energy, communications, maritime surveillance, health, and education. Most of this assistance is partially adjusted annually for inflation.

#### THE FEDERATED STATES OF MICRONESIA AND THE REPUBLIC OF THE MARSHALL ISLANDS USED \$1.6 BILLION IN COMPACT DIRECT FUNDING

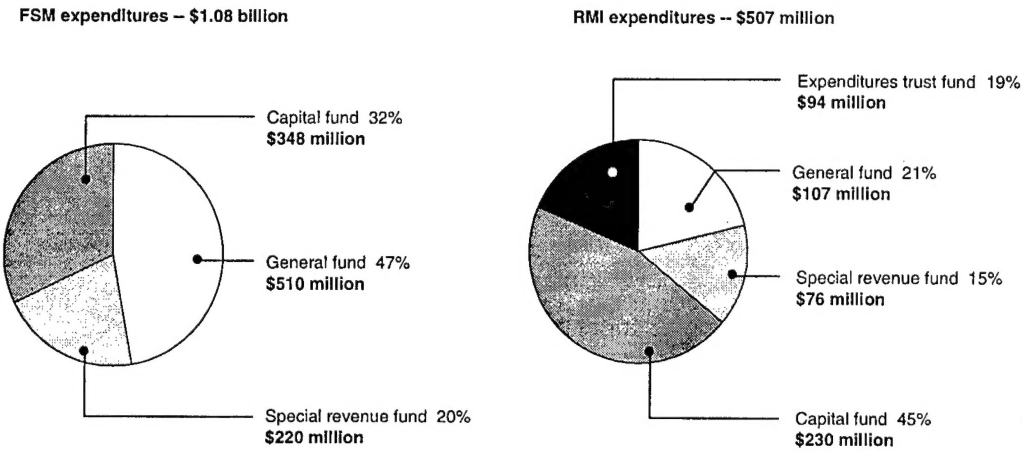
For fiscal years 1987 through 1998, the FSM spent about \$1.08 billion and the RMI spent about \$507 million in funding provided by the Compact (see fig. 1).<sup>4</sup> Each government has used the money differently. The largest area of expenditures in the FSM was for general government operations, which accounted for over 47 percent (\$510 million) of total Compact expenditures. In the RMI, the largest amount of total expenditures, 45 percent or \$230 million, went to support capital fund activities such as building infrastructure, supporting economic activities, and servicing debt.<sup>5</sup>

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<sup>4</sup> When Compact expenditures are converted to constant 1999 fiscal year dollars (using the U.S. gross domestic product deflator), the FSM spent about \$1.2 billion, while the RMI spent about \$582 million. This report uses current dollars throughout.

<sup>5</sup> These figures report on the initial breakdown of Compact funds by government accounts. They may or may not indicate the final use of funds, as these figures for the FSM and the RMI include expenditures from, as well as transfers out of, the accounts. Details regarding the final use of transfers are unavailable in the FSM and RMI financial statements, with a few exceptions, such as the use of transfers for debt service.

Figure 1: FSM and RMI Compact Expenditures by Fund Type as a Percentage of Total Compact Expenditures, Fiscal Years 1987-98



Note 1: The special revenues fund consists of Compact assistance earmarked for specific uses, such as medical referrals, scholarships, and marine surveillance.

Note 2: The expendable trust fund consists of Compact assistance that the RMI government uses to pay about 80 RMI landowners as compensation for the land used by the U.S. military on Kwajalein Atoll.

Note 3: Figures may not add to 100 percent due to rounding.

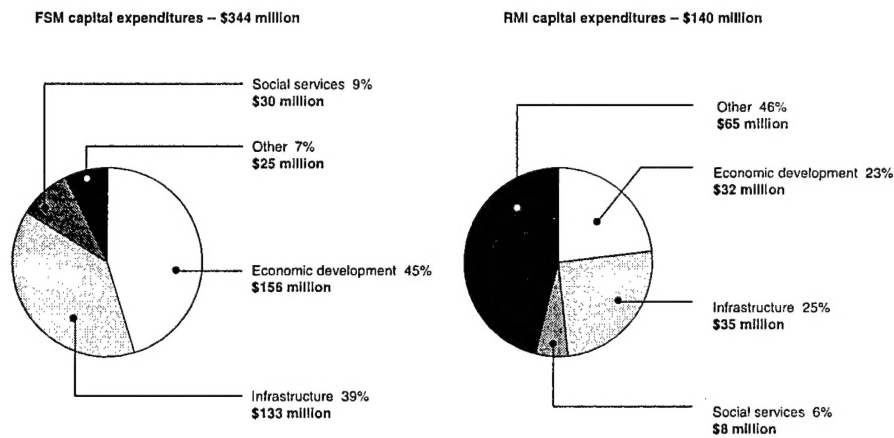
Source: GAO analysis of financial statements and audits of the FSM and the the RMI prepared by Deloitte Touche Tohmatsu for fiscal years 1987-98.

The financial statements of the FSM and the RMI list projects that were paid for from the capital fund.<sup>6</sup> Of these projects, the FSM and the RMI together spent \$484 million from 1987-98 for purposes that included building infrastructure such as roads and schools, and supporting economic development. The FSM spent a total of \$344 million in this area, with \$156 million (45 percent) of these capital project funds going for economic development, such as for fishing boats or processing plants (see fig. 2). Expenditures on infrastructure, followed closely at \$133 million, or 39 percent. For the RMI, 46 percent (\$65 million) of total capital fund expenditures of \$140 million are classified as "other" expenditures. Most of this amount (\$54 million) was listed as unidentified capital expenditures in the RMI financial statements. RMI expenditures for infrastructure and economic development accounted for 25 percent (\$35 million) and 23 percent (\$33 million), respectively, of these capital funds.

<sup>6</sup> These expenditure data for the FSM and the RMI include only expenditures listed in country financial statements. Capital fund transfers and capital expenditures made from bond proceeds are not included.



Figure 2: FSM and RMI Compact Capital Account Expenditures, Fiscal Years 1987-98



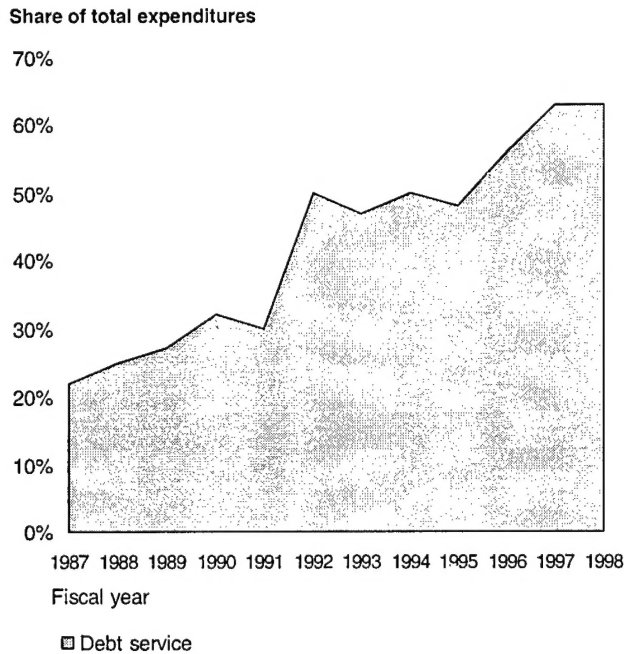
Note 1: "Other" expenditures include land lease and acquisition, resource management, and unspecified uses of funds.  
 Note 2: "Social" expenditures include spending on health, education, housing, training, and social services projects.

Source: GAO analysis of FSM data, compiled by the Joint Committee on Compact Economic Negotiations, and of RMI financial statements prepared by Deloitte Touche Tohmatsu for fiscal years 1987-98.

The Compact does not have guidelines to control the timing of the expenditures. Using this flexibility, from the late 1980s to the mid-1990s, the FSM and the RMI issued nearly \$389 million in Compact revenue-backed bonds in order to obtain greater funding in the earlier years of the Compact. This funding was used to retire existing debt, pay for capital projects, and make financial investments. By fiscal year 1998, the FSM had repaid \$119 million in bond debt, with these repayments accounting for 11 percent of total Compact expenditures. However, the RMI has used a higher percentage than the FSM of its Compact funding to repay bond debt (42 percent or \$217 million) over the life of the Compact. This has limited RMI Compact discretionary spending options, particularly in recent years (see fig. 3). For example, in 1998, the RMI spent \$39 million in Compact funds. Of this total amount, \$25 million went to service debt. The RMI was also required to spend an additional \$8 million to compensate landowners for U.S. military use of Kwajalein Atoll.<sup>7</sup> This left only \$6 million (15 percent) in Compact expenditures to support new capital investment, general government operations, or particular sectors identified in the Compact.

<sup>7</sup> The legislation enacting the Compact recognizes that there is a lease agreement between the government of the RMI and Kwajalein landowners. The United States provides funding to the RMI, which is then used to compensate landowners, per the lease agreement, for the land used by the U.S. military on Kwajalein Atoll. According to an official at the U.S. embassy in the RMI, use of these funds, which are distributed based on acreage owned by each landowner, is at the discretion of each landowner. This official reported that four landowners receive one-third of the annual payment based on acreage owned, with one landowner receiving half of this amount.

Figure 3: RMI Debt Service as a Percentage of Annual Compact Expenditures, Fiscal Years 1987-98



Source: GAO analysis of financial statements and audits of the RMI prepared by Deloitte Touche Tohmatsu for fiscal years 1987-98.

THE FEDERATED STATES OF MICRONESIA AND THE REPUBLIC OF THE MARSHALL ISLANDS HAVE MADE SOME IMPROVEMENTS IN ECONOMIC SELF-SUFFICIENCY BUT REMAIN DEPENDENT ON U.S. ASSISTANCE

The FSM and the RMI are among the largest recipients of U.S. assistance worldwide on a per capita basis. In 1998, total U.S. assistance equated to about \$760 per capita in the FSM and about \$1,095 per capita in the RMI. This high level of per capita funding has maintained artificially high standards of living in both countries that would, according to the Asian Development Bank, collapse in the absence of U.S. assistance. The dependence of these two countries on total U.S. assistance, the indicator we have chosen to gauge economic self-sufficiency, is identified by calculating the percentage of total FSM and RMI government revenues accounted for by all U.S. funding. Total U.S. assistance (Compact and all other U.S. program assistance) <sup>8</sup> still accounts for at least half of total government revenue in both countries, though government dependence on U.S. funds has fallen from 1987 levels in both countries.<sup>9</sup>

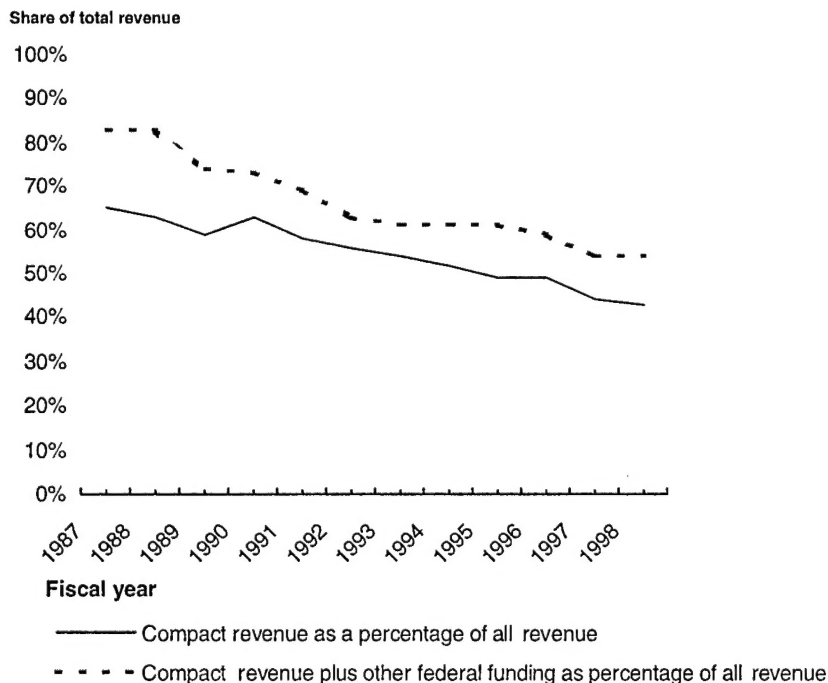
<sup>8</sup> Total U.S. program assistance outside of the Compact for fiscal years 1987-98 for both countries was \$368 million. This was 19 percent of total U.S. funding provided to both nations, with the remaining 81 percent of U.S. funding provided as direct Compact payments.

<sup>9</sup> These data understate the value of U.S. government contributions to the government of the Compact nations. U.S. government services provided in-kind, such as weather service, disaster relief, development



While the United States is the main contributor to the FSM government's revenues, this dependence has fallen substantially since the Compact was enacted, from 83 percent in fiscal year 1987 to 54 percent in fiscal year 1998 (see fig. 4). This change is due to scheduled reductions in direct Compact funds, increases in locally generated revenue stemming from higher fishing license revenues, and a change in how government revenues are reported.

Figure 4: FSM Dependence on U.S. Assistance, Fiscal Years 1987-98



Note: Total FSM government revenues are comprised of direct Compact funds, U.S. program assistance, and local revenues.

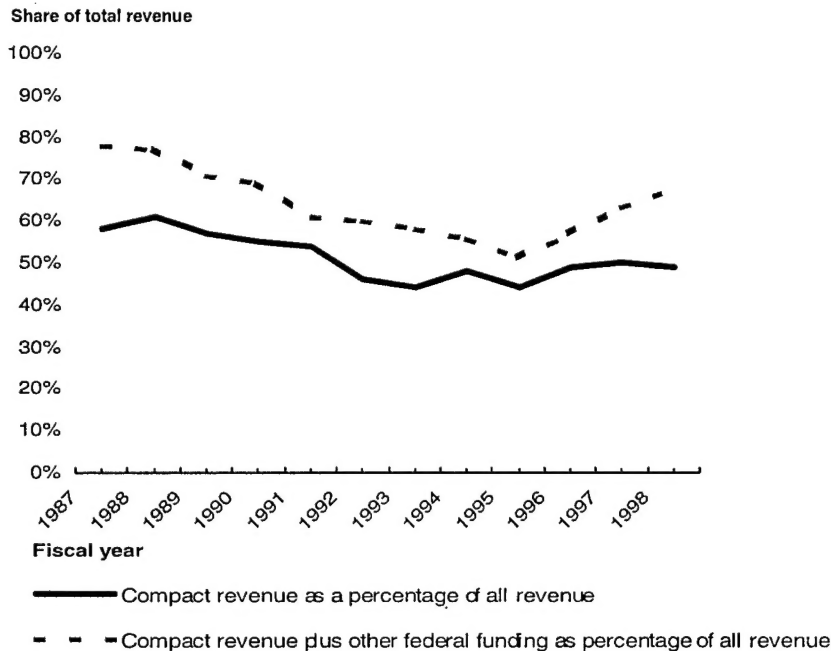
Source: GAO analysis of financial statements and audits of the FSM prepared by Deloitte Touche Tohmatsu for fiscal years 1987-98.

The RMI has also reduced its dependence on U.S. funding, though not as dramatically as the FSM, and its dependence remains higher than that of the FSM. In 1987, U.S. Compact assistance represented 78 percent of RMI government revenue (see fig. 5). This figure fell to 68 percent by fiscal year 1998. However, the 1998 level of dependence represents an increase from 1995, when dependence on total U.S. funding reached a low of 51

loans, and national defense, do not appear as revenue in the FSM and RMI government financial accounts. A complete assessment of changes in self-sufficiency would include contributions of other external donors. To the extent that other external donor revenue is growing while U.S. assistance is decreasing, then self-sufficiency is not improving.

percent. The increase since 1995 is due to decreased local fees, sales, and taxes, and to a change in how government revenues are reported.<sup>10</sup>

Figure 5: RMI Dependence on U.S. Assistance, Fiscal Years 1987-98



Note: Total RMI government revenues are comprised of direct Compact funds, U.S. program assistance, and local revenues.

Source: GAO analysis of financial statements and audits of the RMI prepared by Deloitte Touche Tohmatsu for fiscal years 1987-98.

### COMPACT FUNDS HAVE LED TO LITTLE IMPROVEMENT IN ECONOMIC DEVELOPMENT

Expenditures of \$1.6 billion in Compact funds during 1987-98 in both countries have contributed little to improving economic development. Three areas where Compact expenditures have not led to apparent improvements in economic development are government operations, physical infrastructure, and business ventures. We examined a wide range of projects funded under the Compact and determined that these projects experienced problems for many reasons, including poor planning, management, and construction.

<sup>10</sup> In both countries changes in how social security revenues are incorporated into the government's budget have affected reported government revenue. In the FSM, Social Security Administration revenues have been included in the FSM financial statements since 1991. In that year, these revenues were almost \$5 million. In the RMI, Social Security System revenues have been excluded in the RMI financial statements since 1996. RMI Social Security System revenues in 1995, the last year they were reported, were over \$13 million.

Substantial Compact funds (\$616 million in both countries combined) were used to support general government operations that have maintained high levels of public sector employment and wages and have acted as a disincentive to private sector growth. Public sector wages are higher than those in the private sector in both countries. For example, in the FSM in 1996-97, public sector wages were 82 percent higher than private sector wages. Higher public sector wages attract workers from the private sector and drive up private sector wages. These higher wages make the private sector less competitive in international markets.

The FSM and the RMI also spent at least \$255 million combined in Compact funds for physical infrastructure improvements and operations. The FSM and the RMI viewed this area as critical to improving quality of life and creating an environment attractive to private businesses. For example, in both countries combined, Compact funds of at least \$97 million and \$22 million have been spent to operate and improve energy (including electrical power) and communications (including telecommunications) systems, respectively. Access to and dependability of these services have increased. However, such improvements have not been sufficient to promote significant private sector growth, although we identified one tuna processing plant in the RMI that located to the country in part as a result of dependable electricity.

We identified \$188 million in Compact funds spent in the FSM and the RMI for business ventures. During our visit, FSM and RMI government officials reported that virtually no Compact-funded business ventures were operating at a profit, if at all. Government officials from both countries told us that investing in business ventures has been a bad strategy, and using Compact funds for this purpose had been a failure. One example of this strategy is the \$60 million in Compact funds we identified that the FSM spent on fisheries activities. The FSM has undertaken unprofitable fisheries investments in each of the four states. A 1999 analysis of FSM fisheries ventures, prepared by a consultant for the FSM government, reported that the current valuation of the national and state fishing enterprises,<sup>11</sup> on the basis of expected future cash flows, was zero. We visited one storage and processing facility in each of the four FSM states; none of the facilities were operating at the time of our visit. Officials from Yap and Chuuk said that ventures in fisheries were failures due to inexperience and poor business judgment.

After a review of financial records and/or project files for over 150 projects undertaken with Compact capital account funds, visits to 80 project sites, and numerous interviews in the FSM and the RMI, we determined that many Compact-funded projects (infrastructure and business ventures) experienced problems as a result of poor planning, management, construction, maintenance, and/or misuse. These problems have

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<sup>11</sup> Analysis of the National Fisheries Corporation and its Subsidiaries, W.H.G. Burslem, May 1999 [draft]. The study explains that the National Fisheries Corporation, an entity created to promote the development of the fisheries industry in the FSM, is a public corporation with five current subsidiaries incorporated under normal FSM company law: Yap Fresh Tuna, Chuuk Fresh Tuna, Kosrae Sea Ventures, the Micronesia Longline Fishing Company in Pohnpei, and the Yap Fishing Corporation (which is in receivership). The National Fisheries Corporation no longer has an interest in the Caroline Fisheries Corporation. All ventures are involved in longline tuna fishing for the fresh tuna markets.

reduced the effectiveness of Compact expenditures. According to Department of the Interior officials, the ineffective use of Compact funds can be partially explained by the fact that neither the FSM nor the RMI governments had staff that possessed the skills necessary to plan and manage expenditures under the Compact.

Poor planning and management were evident for many failed projects we visited. One example occurred in the RMI, where the government spent an estimated \$9.4 million in Compact capital funds to build a road, or "causeway," from Ebeye, an extremely crowded island in the Kwajalein Atoll, to a planned development on the nearby island of Gugeegue. This causeway was meant to relieve population problems on Ebeye by allowing residents to move to additional islands connected by the road. However, the causeway remains unfinished due to an inability to budget additional funding to the project, little development has occurred on Gugeegue, and few residents have moved from Ebeye to Gugeegue. Ebeye officials told us that the causeway is covered with water in places during high tide and is considered an inadequate and unreliable connection between Ebeye and the other islands. Construction has been suspended.

Another example of poor planning that we observed was in the FSM state of Kosrae. The state used \$9.3 million in Compact capital account funding within the last 12 years to construct and pave a road around the island. When we visited, the road was in obvious disrepair, and we were told that the road surface had been largely removed. In reviewing the project file for road construction, we found that an inferior, though cheaper, paving technology had knowingly been employed. Kosrae had been informed, prior to construction, that a \$800,000 grant from the U.S. Department of Commerce's Economic Development Authority would not be provided if Kosrae chose this inferior method of building a road. Kosrae chose the cheaper method, never received the Economic Development Authority grant, and is now preparing to pave its roads again.

We also identified instances of poor construction and maintenance. For example, the capitol building in the RMI, built during the 1990s using \$8.3 million in Compact funds, has visible signs of deterioration. Metal stairs are rusting, elevators are inoperable, and roof leaks are evident throughout the building.

Finally, we identified Compact expenditures that appeared to be a misuse of funds. For example, in the FSM state of Chuuk, the Udot road and dock project was intended to upgrade basic social and economic infrastructure in Udot. However, Chuuk state officials indicated that in their opinion, this project would not meet this goal. The project cost at least \$188,000 in Compact funding. When we visited the site, we noted that the dock was built directly in front of the Mayor's house and the road led from the Mayor's house through the jungle to a small village, with few other houses along the road. In contrast, at the end of the Mayor's road was a junior high school that had received \$2,800 in Compact funding to repair the one-room schoolhouse. There were no desks or chairs for students. Further, we were told that students did not have their own textbooks and were read to by the teacher who used the one set of available textbooks.

In the FSM, the Public Auditor as well as officials from the U.S. embassy have cited other instances of misused funds, including the purchase of numerous boats and automobiles

in Chuuk to distribute to individuals in what embassy officials have called the "cars for votes" and "boats for votes" projects.

THE FEDERATED STATES OF MICRONESIA, THE REPUBLIC OF THE MARSHALL ISLANDS, AND THE UNITED STATES HAVE PROVIDED LIMITED ACCOUNTABILITY OVER COMPACT EXPENDITURES

The FSM, the RMI, and the United States have provided limited accountability over the use of Compact funds. Although the Compact established accountability requirements for all three countries, they have not fully complied with the requirements. The FSM and the RMI have usually submitted the required development plans and reports, but these documents fell short of meeting their intended purposes. In addition, the FSM and the RMI have not demonstrated adequate control over the use of Compact funds. Finally, interagency disagreements in the United States on the level of and responsibility for oversight, as well as a Compact provision guaranteeing payment of Compact funds, have limited the U.S. government's ability to meet its accountability requirements.

Compact Required Accountability for Use of Funds From the Federated States of Micronesia, the Republic of the Marshall Islands, and the United States

The Compact required the FSM, the RMI, and United States to account for the use of Compact funds through development plans, annual reports, financial audits, and bilateral consultations. The FSM and the RMI were responsible for preparing overall economic development plans at least every 5 years. Among other things, the plans were required to serve as a program for annual development by identifying specific economic goals and also to identify specific projects and link them to development goals. The FSM and the RMI were also responsible for preparing annual reports on the implementation of the development plans and the use of Compact funds and for performing annual financial and compliance audits. The Compact required the United States to review the development plans for compliance and consistency with the Compact and to assist in identifying appropriate development goals. The United States was also required to meet annually with the FSM and the RMI to review the annual reports and discuss the use of Compact funds. The Compact designated the Department of the Interior to provide and monitor Compact funds. A 1986 executive order established an interagency group, chaired by the Department of State, to provide policy guidance on the Compact.

Planning and Reporting Documents of the Federated States of Micronesia and the Republic of the Marshall Islands Were Generally Incomplete and Insufficient

While the FSM and the RMI generally met the Compact requirements to submit national economic development plans and annual reports to the United States,<sup>12</sup> both types of documents have been insufficient to meet the Compact requirements. Our analysis of the economic development plans, confirmed by Department of the Interior officials and

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<sup>12</sup> The FSM and the RMI submitted economic development plans for the first and second 5-year periods, covering the period from 1987 to 1997. The FSM presented other development documents in lieu of a third 5-year plan, which the United States has accepted. The FSM submitted annual reports each year from 1987 to 1998, while the RMI has submitted 7 of the 12 annual reports.

an FSM government document, found that the plans gave inadequate attention to broad development goals and plan implementation, as required by the Compact. Department of the Interior officials said the plans focused on spending funds in specific sectors without tying projects to development needs. However, a Department of State official said an FSM planning document for the 1999-2001 period represents an improved effort. Further, Department of the Interior officials told us that the annual reports, which are required by the Compact as a means of assessing economic progress, were also inadequate at describing how Compact funds were used to achieve development goals. Without this annual assessment, Interior officials were unable to determine whether the use of Compact funds was contributing to Compact goals. Although State and Interior were generally critical of the quality of the reports, a State Department official noted that the quality of FSM annual reports has improved over time, while the quality of RMI reports has deteriorated.

In addition, the FSM and the RMI have failed to adequately control and account for Compact expenditures. According to their annual financial audits, the FSM and the RMI did not maintain or provide sufficient financial records to effectively audit Compact funds. Further, program audits by the FSM Public Auditor found inappropriate use of Compact funds and extensive management weaknesses in accounting for Compact funds. For example, an audit of Compact-funded projects for fiscal years 1997 and 1998 found that 37 of 42 project examined were not properly managed and had deficiencies such as improperly documented payments. An audit of Compact-funded projects for fiscal years 1992-96 found problems related to misuse of funds, as mentioned earlier. For example, the audit found that nearly \$600,000 of heavy equipment purchased for a \$1.3-million road improvement project in Tolensome, Chuuk was being used at a former mayor's personal dock for activities not related to road improvement. Finally, the independent audits showed that the two countries have taken little action to address management weaknesses and resolve questioned uses of Compact funds. For example, by fiscal year 1998, the two countries wrote off over \$50 million in questioned uses of Compact and other program assistance that had been unresolved since the 1980s.<sup>13</sup>

#### The U.S. Government Did Not Meet Many Accountability Requirements

The U.S. government has not met many of the Compact's accountability requirements to review and consult on Compact expenditures. We found that the U.S. government concurred with and praised the initial development plans of both countries, although Interior officials informed us that U.S. concerns over the plans remained. Further, although the Compact requires the U.S. government to review each FSM and RMI overall economic development plan to, among other things, assess whether they include appropriate development goals, we found references that only two (the first plans for the FSM and the RMI) of the four submitted plans had been reviewed. In addition, the United States did not initiate the required annual consultations with the two countries until 1994. The United States has held four additional consultations with the FSM and three consultations with the RMI since 1994. According to a Department of the Interior

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<sup>13</sup> While the FSM and the RMI were responsible for providing plans to address these questioned costs, the U.S. government never pursued final resolution of these costs.



official, the talks have been cordial diplomatic meetings but have not included serious discussions of economic growth or compliance with Compact spending requirements. As a result, the FSM and the RMI were not required to demonstrate their progress in economic development and justify their Compact expenditures on a regular basis.

#### U.S. Oversight Limited by Interagency Disagreements and Interior's Belief That Compact Provisions Restricted U.S. Actions

Disagreements between the Departments of State and the Interior on the level of and responsibility for Compact oversight have led to reduced monitoring efforts. The following examples illustrate areas of disagreements:

- Although the Department of the Interior initially sought more accountability requirements in the Compact, the Department of State counseled Interior to be lenient in reviewing the use of Compact funds in the early years of the Compact because State placed high priority on maintaining friendly relations with the FSM and the RMI. According to a Department of State official, the Department did not place greater priority on oversight of Compact funds until the early to mid-1990s, after the Cold War had ended.
- Disagreements between the Departments regarding authority over Interior staff selected to work in the RMI, as well as where Interior staff would be located within the country, partially explain why there are currently no Interior staff working in the RMI.
- Disagreements over agency responsibilities help to explain the lack of consultations with the FSM and the RMI from 1987 to 1993. Department of the Interior officials told us that the Department of State is responsible for initiating discussions regarding Compact issues with the FSM and the RMI as part of its responsibility for "government-to-government relations" with the two countries and as chair of the interagency group that establishes policy regarding the two countries. However, Department of State officials maintain that the Department of the Interior, as the agency responsible for providing Compact funding, should have requested meetings with the FSM or the RMI regarding Compact expenditure issues. Consultations began in 1994 and are now supported by both Departments. By not holding the required consultations for the first 7 years of the Compact, the United States missed opportunities to discuss annual Compact expenditures and progress in economic development with both countries when the FSM and the RMI governments were in a formative stage and Compact assistance was at its highest level.

In addition, Department of the Interior officials believe that Compact provisions guaranteeing payment of funds to the FSM and the RMI limit the Department's ability to require accountability. They told us that while the Compact and a related agreement on fiscal procedures refer to direct payments for economic assistance as "grant assistance," these payments are not the same as discretionary grant assistance as commonly understood in domestic U.S. programs where requirements such as performance

measures can be applied to control the use of funds. Further, Interior officials told us that the Compact payments are expressly backed by the "full faith and credit" of the United States government and are intended to be an enforceable obligation. If the United States withholds funds or otherwise fails to make a payment, the FSM and the RMI can seek redress in court.

As a result, Department of the Interior officials told us that they are unable to withhold funding from the FSM and the RMI and essentially have no mechanism to ensure that funds are not misused. Department of State officials agree that withholding funds is impracticable. Interior and State officials also said that even if they could withhold funds, the broad range of acceptable Compact expenditures listed in the agreement on fiscal procedures would make it difficult to demonstrate that a questionable expenditure was not allowed.

### OBSERVATIONS

Throughout the course of our work, officials from all three countries identified issues that they feel need to be resolved during the course of negotiations. These issues include (1) defining the objective of future economic assistance, (2) establishing the duration and amount of funding, (3) determining the funding mechanism (block grants, project funding, or a trust fund), (4) specifying the degree of accountability over expenditures, and (5) determining how this future assistance will be administered.

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Mr. Chairman and Members of the Subcommittee, this concludes my prepared remarks. I will be happy to respond to any questions you may have.

### CONTACTS AND ACKNOWLEDGEMENT

For future contacts regarding this testimony, please call Susan Westin or Emil Friberg at (202) 512-4128. Individuals making key contributions to this testimony included Edward George, Jr., Leslie Holen, and Dennis Richards.

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